

Airlines

Day One Trading - Current Industry Summary

Companies Mentioned: AAI, ACAI*, ALK, AMR, AMTR*, AWA, CAL, CGO, DAL, FRNT*, LFL, LUV, MESA*, NWAC*, SKYW*, U, UAL

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Highlights

- ▶ In the current economic and political environment, the airline industry is expected to be more negatively affected than any other business since airlines are not only economic sensitive but demand can be volatile depending on external political factors such as terrorism.
- ▶ It is anyone's guess when traffic levels may rise again to even near normal levels, and until this happens virtually all airlines are in "harm's way," with most carriers potentially facing a liquidity crisis if relief is not obtained from the government.
- ▶ If carriers can make it through this difficult period, longer term with the airlines sharply cutting back on schedules and future capacity and the possibility of marginal carriers disappearing the industry may benefit.
- ▶ Although the only major airline that we believe can remain economically viable through any prolonged downturn without some form of government assistance to the industry is Southwest Airlines, some of the other major airline stocks (the expected survivors) are currently very cheap in our opinion, and although they may remain cheap for a while, we believe they are potentially attractive for investors with a two to five year time horizon. We would look at Delta Air Lines (DAL), AMR Corporation (AMR), and Northwest Airlines (NWAC).

Reason for note: Industry Update

In the current economic and political environment, the airline industry is expected to be more negatively affected than any other business, since airlines are not only economic sensitive but demand can be volatile depending on external political factors such as terrorism. It is anyone's guess when traffic levels may rise again to even near normal levels, and until this happens virtually all airlines are in "harm's way," with most carriers potentially facing a liquidity crisis if relief is not obtained from the government.

If there are no further incidents that continue to scare the public, and if any U.S. response is low key or drawn out, we believe that business travel will return to levels justified by the economy by year-end at the latest. Business must go on and if the airline system is considered safe with the stepped up security, we believe that business travel will return (especially if there are price inducements offered by airlines). However, we are now assuming that the economy will be knocked into a recession for the next two or three quarters as a result of weakened consumer confidence, which will keep pressure on business travel levels. Leisure travel in all probability will be slower to return. As a result, it can be expected that airlines will be doing heavy ticket price discounting for the remainder of the year to fill empty seats even at reduced flight levels.

Flashnote

Longer term, however, with the airlines sharply cutting back on schedules and future capacity, and the possibility of marginal carriers disappearing, the industry in general may benefit. With airlines trying to fill every seat through very accurate yield management techniques, the system had reached an “overload” situation where carriers were achieving record traffic and load factor levels but at the expense of service reliability and an overload of the infrastructure, needlessly wearing out assets (both human and equipment). Pricing policies were in place to induce additional traffic at marginal levels that may have not been worth the effort. With excess inventory (seats) taken out of the system and lower load factor target levels, airlines should be able to more than make up the difference in stronger yields.

With prices of major airline stocks being down from twenty-four to sixty-five percent, there may be some bargains for the long-term investor, willing to bet on the economy and the industry. The only major airline that we believe can remain economically viable through any prolonged downturn without some form of government assistance to the industry is Southwest Airlines (NYSE: LUV- 13.00, Buy). The carrier has a strong balance sheet (the strongest in the industry by a substantial margin) and is the least leveraged of any of the major carriers. It is solely a domestic carrier operating a single type of narrow-body aircraft, tends to avoid major and hub centered airports and primarily operates over shorter routes (passengers take less baggage). Even though their operation is expected to be slowed down by increased security procedures, we believe that they may pick up market share as the larger carriers decide to “spill” some of its lower yielding traffic through seat inventory reductions.

Some of the regional carriers with fixed rate contracts also look attractive at their new lower price levels. If their major partners cut schedules, employees and other costs it is probable that they will try to re-negotiate their contracts with their regional partners. However, the regional jets that the regional airlines operate and will continue to receive make them more valuable than ever, we believe, to their larger partners and any new contract should be a fee-per-departure contract which will give some predictability to earnings and growth as the current contracts do. SkyWest Airlines (NASDAQ: SKYW- 19.15, Buy) and Atlantic Coast Airlines (NASDAQ: ACAI- 17.02, Buy) are the two premier carriers in this category.

The downturn in air travel may not be as great or as long as estimated but regardless, we believe that airlines will need some government assistance to get them through this extraordinary one-time crisis period. Having a financially stable and vibrant industry is absolutely necessary for the national and world economies and politicians cannot afford to have an entire industry such as this go bankrupt. We do not see the government wanting the burden of a financially crippled industry, re-regulation of the industry, nor a public corporation such as Amtrak that they would have to subsidize, and therefore we believe that some form of temporary assistance will be extended. This help could come in the form of:

1. A cash infusion of an estimated two to three billion dollars to make up for estimated losses the industry has incurred as a result of the shutdown after the terrorist act, and the initial impact of lost revenues once the system began operations again. This payment, we believe, can be justified since the incident was beyond the control of the industry and was a one-time disaster and not related to normal market conditions.
2. A rebate and repeal of the 4.4 cent fuel tax.
3. Relief on excise and cargo taxes for the next year or two.
4. Government guaranteed loans to provide additional liquidity during the crisis that would be paid back.
5. The government assuming the costs of airport security, which in our opinion should be done by a government entity to begin with.

We believe that some form of help is needed for the industry to survive this crisis and that such help will be provided. Assuming that the whole industry survives this crisis, some airline stocks (the expected survivors) are currently very cheap in our opinion, and although they may remain cheap for a while, we believe they are potentially attractive for investors with a two to five year time horizon. We would look at Delta Air Lines (NYSE: DAL- 20.64, Hold), AMR Corporation (NYSE: AMR- 18.00, Hold), and Northwest Airlines (NASDAQ: NWAC- 12.42, Hold). Continental Airlines

(NYSE: CAL- 20.05, Hold) might also be interesting but they are in immediate danger of default on some of their EETC payments (which we believe will be made in some timely manner).

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